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LONG-RUN RANGES

Donald L. Kohn

As background for Committee discussion of its intermediate-term objectives and approaches to monetary policy, the bluebook presented three alternative policy strategies, summarized in a table on page 8. These simulations, using the staff econometric model are, at best, only rough approximations of the economic outcomes that might go with alternative financial conditions. Nonetheless, the exercise suggests a few points the FOMC might want to keep in mind as it thinks about policy over the course of 1993.

The first concerns the current situation. In fact, the economy is not that far from both full employment and reasonable price stability. As a result, policies that lean significantly in favor of one or the other of these objectives risk overshooting before too long. For example, easier strategy III, which involves an immediate drop in the federal funds rate and an increase in M2 growth, produces 3-1/2 percent growth in output for two years--somewhat less than the political rhetoric would seem to call for--but returns the unemployment rate to close to its natural rate by the end of 1994. This strategy thus requires significant tightening over 1994 to forestall accelerating inflation in 1995. A comparable lesson can be drawn from the tighter strategy: Unless tightening is fairly mild, as in the strategy presented, sufficient slack builds up to set in train forces of deflation after a few years. One implication of starting so close to both full employment and price stability is that policymakers probably need to be ready to take corrective action fairly promptly if it turns out that the results are coming in with either a much faster return to full employment or much more disinflation than contemplated.

A second point from the exercise is that indexing monetary policy on M2 growth--or judging the policy stance from this indicator--is far from straightforward. We used the new Feinman-Porter money demand model for our exercises--augmented with additional equations to get the necessary components of opportunity cost as well as a good bit of judgment. In the new model, the demand for M2 is fairly insensitive to changes in short-term rates, which by itself would be a desirable property of a targeted monetary variable if the Committee were willing to let interest rates fluctuate over a wide range. But the model also indicates that the relationship of money to spending is sensitive to the tilt of the yield curve and other variables not under the control of the Federal Reserve. And the fact that a new model needed to be constructed at all and that the staff is already judgmentally adjusting its results suggests considerable uncertainty about the behavior of velocity, especially in the midst of massive balance-sheet restructuring by depositories and their customers. As you can see from the top lines of the table, in general the easier policy entails more M2 growth than the baseline, and the tighter policy less--but the amounts vary over time and do not line up tightly with the differences in nominal GDP growth.

The lack of a nominal money anchor in which the Committee can have confidence may be especially troublesome at a time when uncertainties about the relation of spending to interest rates abound. The abating of the balance sheet adjustments, or whatever has been damping spending in recent years, is one source of unusual uncertainty. In this regard, the simulations followed the greenbook forecast of a gradual loosening of credit terms and standards and more comfort with financial positions. The simulations also used the greenbook fiscal policy assumptions. If monetary policy wanted to damp, without completely offsetting, the effects on spending and inflation of any fiscal policy initiatives, a classic textbook prescription would be to adhere to a predetermined money supply path. In the absence of a predetermined money supply path the Committee feels comfortable with, judging the appropriate federal funds response to fiscal policy would be difficult. Delayed fiscal restraint could be stimulative in the near term if financial markets respond promptly with lower long-term rates, while the reaction of spenders to prospective increases in taxes or reductions in government spending is damped or does not occur until the actual restraint takes hold. Especially if the delayed restraint is coupled with a debt management strategy that successfully puts additional downward pressure on long-term rates, near-term fiscal stimulus, and perhaps even regulatory actions that encourage lending, the combination could boost aggregate demand significantly for a time. Moreover, movements in long-term interest rates through this period may not give the Federal Reserve very much guidance on the credibility of fiscal restraint, since markets will also be pricing in the effects of near-term stimulus--to the extent it differs from current expectations--and the Federal Reserve's reaction to the entire package. This suggests caution in reacting to any fiscal initiatives, and especially in the interpretation of the implications of financial market responses for the appropriate path of short-term interest rates.

The staff's assessment of the likely growth of the monetary aggregates under the greenbook forecast is given in detail on page 11 of the bluebook. We are projecting the same growth in M2 and M3--2 and 1/2 percent, respectively--for 1993 that we experienced in 1992. Nominal GDP is projected to continue to grow 5-1/2 percent, so this implies that the velocities of M2 and M3 will register the same sizable increases in 1993 that they did in 1992. That result, however, reflects some shifting in the underlying forces acting on the relationship of money and spending. On the one hand, the intensity of some of the unusual forces tending to depress M2 and M3 and raise their velocities should abate a bit this year--though they would still be working in the direction of pushing velocity higher. For example, as already noted, we expect some ebbing in the pace of balance-sheet rebuilding by borrowers and more readily available credit through financial intermediaries. Partly for these reasons, we are forecasting a pickup in debt growth in 1993--to 5-1/4 percent--with all of the strengthening coming outside the federal sector. In addition, the slope of the yield curve is expected to flatten this year, and some of the portfolio restructuring prompted by the wider spread between returns on M2 and those on longer-term assets or debt repayment should begin to taper off. On the other hand, several factors will be damping demands for M2 and M3 and working to raise velocity in 1993 relative to 1992. For one, velocity in 1992 was probably held down by declining short-term interest rates, which provided at least temporary yield advantages to liquid M2 assets, and the greenbook forecast assumes flat short rates in 1993. Moreover, the RTC is expected to resume closing institutions in 1993, and mortgage repayments are not likely to be providing the boost to M2 and M3 growth they did in 1992.

Against this background, the bluebook offers two alternative sets of ranges for 1993. Alternative I carries over the provisional ranges set for this year in July. Those ranges do not encompass the staff projections for M2 and M3, and their choice would seem to connote either skepticism about the staff velocity forecast or a desire to promote somewhat faster growth in nominal GDP than in the greenbook forecast. If the staff assessment of money demand and its outlook for the underlying strength of aggregate demand in the economy is about correct, a sizable decline in interest rates would seem to be called for to raise the odds on pushing the aggregates to within their alternative I ranges. We persist in believing that lower interest rates boost M2 growth, but with a steeping yield curve and prompt response of deposit rates acting to damp the response of M2 to lower short-term interest rates, our rough judgment is that the federal funds rate would need to be decreased by perhaps 1/2 percentage point or even more in the first quarter to achieve 2-1/2 percent M2 growth by the fourth quarter of this year.

Alternative II would lower the M2 and M3 ranges a full percentage point, encompassing the staff projections. The provisional ranges were chosen in large part because the Committee said it was uncertain about likely velocity behavior in 1993. Velocities rose quite strongly in the last half of 1992--even in the face of further declines in market interest rates--and this development, along with subsequent analysis of M2 demand, may give the Committee somewhat more confidence that another sizable velocity increase is in store for 1993. Even the reduced ranges of this alternative would provide ample room for faster money growth than the staff forecast, should velocity begin to return more to normal or should the Committee desire a stronger economy. With regard to velocity behavior, the old staff M2 model, which has been overpredicting M2 growth for three years, sees M2 growth of only 4 percent as consistent with the greenbook forecast in 1993, as money demand is held down by further adjustments in liquid deposit rates.

Alternative II does not include a reduced range for growth of the debt of nonfinancial sectors. The staff forecast is for debt growth in the lower half of the provisional range, which was carried over from 1992. Not lowering the range might tend to underline the "technical" nature of the adjustment to the money ranges. But a good case can be made for moving the debt range down as well--perhaps by 1/2 percentage point. Not only would a lower range be more centered on expectations, but it would reinforce the notion that outsized debt growth was not a healthy development, and that the Federal Reserve saw slower debt growth than in the 1980s as a key element in a sustainable expansion.

Of course other alternatives for money ranges are possible. One would be to reduce the ranges by only 1/2 percentage point. The central tendency of your projections for nominal GDP is slightly stronger than the staff's forecast, suggesting that your M2 projections might plausibly be a bit above those of the staff. Moreover, the staff has made judgmental downward adjustments to the results of the Porter-Feinman model, which is predicting in the area of 2-1/2 percent M2 growth for 1993 with the greenbook forecast. More generally, if loan growth picks up substantially, and as savers' portfolios become more fully adjusted to the emerging structure of returns, velocity could settle down more than we have predicted. These factors suggest that M2 growth above the lower end of a 2 to 6 percent range is possible, though money is likely to run well below that range, especially in light of the very weak start to the year, and end the year near the lower end.

Another alternative would be to reduce only the lower end of the money ranges. A wider range could be rationalized on the grounds of greater uncertainty about velocity, though ranges are already fairly wide--one percentage point wider than in the early and mid-1980s. The reduced lower end would signify a willingness to allow slower money growth if velocity does increase as expected; retaining the upper end would suggest a willingness to accommodate to much faster M2 growth if that were necessary to support expansion. In that regard, retaining the higher upper end might allay some concerns that the Federal Reserve will act to stifle economic growth before long, perhaps offsetting any expansionary impact of near-term fiscal stimulus. While there is logic in this argument, it would do little to reassure the critics who are most concerned about getting M2 up into the current range.

Finally, I would draw the Committee's attention to the long-run portion of the directive. This section already has a sentence about expecting unusual increases in velocity to continue. That sentence would seem especially appropriate to retain if the Committee reduces the ranges.

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SHORT-RUN POLICY
Donld L. Kohn

Mr. Chairman, I don't sense a multiplicity of short-run policy issues in front of the Committee today, so I will be brief. Although the monetary aggregates are not getting much weight in policy, their recent weakness has been extraordinary--even by the standards of the past year--and I thought it might be worthwhile to spend just a minute or so on their behavior.

At the December meeting, the staff was anticipating quite damped M2 growth in December and January and a slight decline in M3, partly as some special factors that had boosted the aggregates in previous months unwound. In the event, M2 fell and M3 dropped more than projected. Moreover, we are anticipating another decrease in both these aggregates, and in M1 as well, in February. [I might add that the preliminary data available this morning suggest that if anything the broad aggregates are coming in weaker than we had projected for the week just ended.] It now appears that mortgage refinancing abated faster than we had anticipated in December. Another part of the story presumably is the difficulty of sorting out underlying trends from noise around year-end--especially when year-end window-dressing takes on an entirely new meaning in an age of concern about capital ratios and balance sheet safety. Further seasonal complications account for part of the weakness forecast for February; strong growth in the aggregates in the past two Februarys as a consequence of easings in December have fooled the seasonal adjustment procedures into thinking that a new seasonal pattern is emerging in the data.

Beyond these special stories, however, the aggregates remain very soft. The surprises relative to our expectations are in the liquid components, especially savings deposits and MMDAs, but with money market funds and NOW accounts also showing signs of weakness. Savings and MMDAs decelerated from months of 10 percent or more growth to 6 percent in December and a decline in January. This change has occurred without a sudden shift in opportunity costs of these deposits over the past few months. One hypothesis is that the liquid accounts are being used to pay for purchases--either directly or through repaying credit card debt--and elevated estimated tax payments in January. Drawing down such deposits certainly is less costly than borrowing or divesting nearly any other financial asset.

Thus, the weak money supply on this view is seen as supporting concurrent spending, not indicative of underlying weakness. In fact, we are predicting growth in M2 velocity at a more than 7 percent annual rate in the first quarter and in M3 velocity at more than a 9 percent rate, with no change in M1 velocity after 10 straight quarters of decline. Our projections for the balance of the quarter do encompass some mild strengthening of money growth in March--partly on the theory that declines in money of this magnitude and increases in its velocity aren't sustainable. People will begin to rebuild balances at some point. In a sense, the money data are the counterpart of the strength in spending through a declining savings rate--and the forecast pickup in money the other side of concerns some of you expressed about the sustainability of that spending without some pickup of income growth.

The drop in money growth is not echoed in bank lending. Overall bank credit in January has softened, but only because securities ran off. Bank loans increased in December and January, with a fall in business loans in December about matched by an increase in January. But loan growth hasn't strengthened much. And the aggregate debt of nonfederal sectors, while growing a little faster in the fourth quarter than in the first three quarters of the year, remains damped. Overall, the financial data might be read as suggesting that the headwinds have not died out entirely, reinforcing a sense of two-way risk to the outlook, despite the spate of favorable nonfinancial data and improving attitudes.

Finally, our projection for declines in the broad aggregates over the December-to-March period does raise a question about what to put in the operational paragraph of the directive. That paragraph normally would contain a reference to the December-to-March period, as in the directive draft in the bluebook. As an alternative, and with January behind us, the Committee's expectations for the period immediately ahead might be better summed up by noting that, in the case of alternative B, reserve conditions are expected to be consistent with little change on balance in the broad money aggregates over the period from January to March.